

**COMMONWEALTH OF MASSACHUSETTS  
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

**Fitchburg Gas and Electric Light Company )**  
**Complaint of the Attorney General to Reduce the Electric ) D.T.E. 99-118**  
**Rates of Fitchburg Gas and Electric Light Company )**

## DIRECT TESTIMONY OF DAVID J. EFFRON

**On behalf of**

**THE OFFICE OF THE ATTORNEY GENERAL**

**February 9, 2001**

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**STATEMENT OF QUALIFICATIONS**

1 I.

2 Q. Please state your name and business address.

3 A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield,  
4 Connecticut.

5

6 Q. What is your present occupation?

7 A. I am a consultant specializing in utility regulation.

8

9 Q. Please summarize your professional experience.

10 A. My professional career includes over twenty years as a regulatory consultant, two years  
11 as a supervisor of capital investment analysis and controls at Gulf & Western Industries  
12 and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified  
13 Public Accountant and I have served as an instructor in the business program at  
14 Western Connecticut State College.

15

16 Q. What experience do you have in the area of utility rate setting proceedings?

17 A. I have analyzed numerous electric, telephone, gas and water rate filings in different  
18 jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys  
19 in rate case preparation, and provided assistance during settlement negotiations with  
20 various utility companies.

21 I have testified in approximately two hundred cases before regulatory  
22 commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana,

1 Kansas, Kentucky, Maryland, Massachusetts, Missouri, New Jersey, New York, North  
2 Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas and Virginia.

3

4 Q. Please describe your other work experience.

5 A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was  
6 responsible for reports and analyses concerning capital spending programs, including  
7 project analysis, formulation of capital budgets, establishment of accounting  
8 procedures, monitoring capital spending and administration of the leasing program. At  
9 Touche Ross & Co., I was an associate consultant in management services for one year  
10 and a staff auditor for one year.

11

12 Q. Have you earned any distinctions as a Certified Public Accountant?

13 A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest  
14 scores in the May 1974 certified public accounting examination in New York State.

15

16 Q. Please describe your educational background.

17 A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College  
18 and a Masters of Business Administration Degree from Columbia University.

19

20 **II. PURPOSE AND SUMMARY OF TESTIMONY**

21 Q. On whose behalf are you testifying?

22 A. I am testifying on behalf of the Office of the Attorney General.

23

1 Q. What is the purpose of your testimony?

2 A. I am presenting a calculation of the excess revenue presently being produced by the  
3 electric distribution rates of Fitchburg Gas and Electric Light Company (“FG&E” or  
4 “the Company”).

5  
6 Q. Please summarize your conclusions.

7 A. The electric distribution rates presently in effect are producing excess distribution  
8 revenue of \$3,116,000.

9 **III. ELECTRIC DISTRIBUTION REVENUE EXCESS**

10  
11 Q. Please explain how you calculated the excess revenue being produced by the electric  
12 distribution rates presently in effect.

13 A. My calculation of the electric distribution revenue excess is summarized on Exhibit  
14 DJE-1, Page 1. As I did not have all the information necessary to conduct a complete  
15 analysis of the electric distribution cost of service and the revenues presently being  
16 produced by electric distribution rates, my calculation of the electric distribution  
17 revenue excess is based on the excess return on common equity earned by FG&E  
18 electric operations. I believe that this calculation produces a reasonable  
19 quantification of the electric distribution revenue excess being produced by FG&E’s  
20 electric distribution rates.

21

22 Q. Did the Attorney General attempt to obtain the information necessary to conduct a  
23 complete analysis of the electric distribution cost of service and the revenues  
24 presently being produced by electric distribution rates?

1 A. Yes. In the Attorney General's Second Set of Information Requests, items AG-2-6  
2 through AG-2-14 requested information that would have enabled the presentation of a  
3 complete distribution cost of service and revenue requirement analysis. The  
4 information requested included data regarding known and measurable changes in  
5 revenues and expenses that would affect the results of distribution operation  
6 prospectively.

7  
8 Q. What was the Company's response to these information requests?

9 A. The Company objected to the requests as being "overly broad, burdensome, and  
10 beyond the reasonable scope of the proceeding as Contemplated by the Department's  
11 procedural schedule". The Attorney General filed a motion to compel the Company  
12 to respond to these information requests. However, at the time of the preparation of  
13 this testimony, the Company had not provided the requested information. Therefore,  
14 the necessary information to conduct complete analysis of the electric distribution  
15 cost of service and the revenues presently being produced by electric distribution  
16 rates was not available to me in the preparation of my testimony. Thus, I based my  
17 calculation of the electric distribution revenue excess on the excess return on  
18 common equity earned by FG&E total electric operations.

19  
20 Q. If the Company's electric operations include functions other than distribution, how  
21 does a calculation of the excess return on common equity earned by total FG&E  
22 electric operations produce a determination of the electric distribution revenue  
23 excess?

1 A. All elements of the Company's rates other than distribution reconcile to the cost of  
2 service associated with those elements. Therefore, if the electric operations produce  
3 an excess return on equity, such excess is the result of distribution revenues that are  
4 greater than the distribution cost of service.

5 The elements of the Company's rates beyond those for distribution services  
6 include internal transmission, external transmission, energy efficiency, renewable  
7 resources, transition charge, and standard offer or default service. The internal and  
8 external transmission revenues are reconciled with the costs of internal and external  
9 transmission service, and any under or over recovery is accrued. The energy  
10 efficiency and renewable resources rates are set by statute, which requires that the  
11 amounts collected through such rates be expended on the programs for which the  
12 charges are intended. The transition charge revenues are reconciled to transition  
13 costs, including a return on the unamortized balance of fixed costs, and any under or  
14 over recovery is accrued. Similarly, standard offer service revenues and default  
15 service revenues are reconciled to the costs of providing these services, and any under  
16 or over recovery is accrued.

17 Thus, the only function of the Company's electric operations where revenues  
18 are not reconciled to the cost of service associated with that function is the  
19 distribution function. If revenues equal costs (including return on investment) for the  
20 functions other than distribution and if total electric revenues exceeds total electric  
21 costs (including a reasonable return), then it is the distribution function that is  
22 producing those excess revenues, which will show up as an excess return on common  
23 equity.

1 Q. How did you calculate the excess return on common equity earned by FG&E electric  
2 operations?

3 A. I have begun on Exhibit DJE-1, Page 1 with electric utility operating income as  
4 shown in the FERC Form 1 for the years 1997, 1998, and 1999. I have shown the  
5 results for three years to establish the continuing nature of the excess return being  
6 earned by the Company's electric operations. Electric utility operating income is all  
7 electric operating revenue less all electric operating expenses, including income  
8 taxes. Although the total electric utility operating income includes production,  
9 transmission, and distribution functions, as I have explained above, to the extent that  
10 there are excess earnings, such excess earnings are attributable to the distribution  
11 function.

12 To calculate the net income available for common equity, I subtracted the  
13 interest expense and preferred dividends from operating income. The net income  
14 available for common equity is the denominator in the earned return on common  
15 equity calculation.

16

17 Q. How did you calculate the interest expense and preferred dividends attributable to  
18 electric operations?

19 A. I allocated total company interest expense and preferred dividends to electric  
20 operations based on the proportion of total capital deemed to be supporting electric  
21 rate base. My allocation of interest expense and preferred dividends is shown on  
22 Exhibit DJE-1, Page 2.



1 I have started with total capitalization, including short-term debt. (The results  
2 would not be materially different if short-term debt were excluded from the total  
3 capitalization.) I then subtracted non-utility property and investments, a small  
4 adjustment, to determine the total capital supporting utility rate base. I allocated the  
5 utility capital between gas and electric based on the ratio of electric net plant to the  
6 total of electric and gas net plant. I believe that this is a reasonable allocator for  
7 capital, as net plant is the main component of rate base. I divided the capital  
8 supporting electric rate base by the total capital to calculate the ratio for allocating  
9 interest expense, preferred dividends and also, later, common equity.

10 I then multiplied the total interest expense and preferred dividends by the  
11 average electric utility capital ratio for each of the years to calculate the interest  
12 expense and preferred dividends attributable to electric operations. The calculations  
13 appear on Exhibit DJE-1, Page 2, and the results are carried to Exhibit DJE-1, Page 1.

14

15 Q. By subtracting interest expense and preferred dividends from utility operating income  
16 in your presentation, are you, in effect, treating interest expense and preferred  
17 dividends as “above the line” operating expenses?

18 A. No. I am subtracting these fixed capital costs from utility operating income to derive  
19 the net income available for common equity and return on common equity, which is  
20 the residual, where any revenue excess or deficiency would show up. Although the  
21 form may be different, this is, in substance, the same as the method used in a  
22 traditional rate case. That is, if a utility company in a rate case has a revenue excess  
23 or revenue deficiency, such excess or deficiency would show up as an excess or

1       deficiency in the return on common equity. The cost rates for debt and preferred  
2       stock, which are fixed, would not be affected by a revenue excess or revenue  
3       deficiency. My calculation of return on common equity does not treat interest  
4       expense and preferred dividends as “above the line” operating expenses. My  
5       calculation subtracts these fixed costs from utility operating income to get to the  
6       “bottom line”, return on common equity, where the effect of any revenue excess  
7       ultimately resides.

8

9     Q.    After calculating the net income available for common equity, how did you calculate  
10       the return on common equity?

11    A.    I divided the net income available for common equity by the common equity  
12       supporting electric utility rate base. The common equity supporting electric utility  
13       rate base was calculated by applying average electric capital percentage to the total  
14       common equity on Exhibit DJE-1, Page 2.

15

16    Q.    What return on equity did you calculate for the years 1997 – 1999?

17    A.    I calculated the following returns on common equity for FG&E electric operations:

18	1997	21.41%
19	1998	21.12%
20	1999	18.25%

21       Although I am not presenting expert testimony on the Company’s cost of  
22       common equity, I feel safe in saying that these returns are far in excess of any  
23       reasonable range of the cost of common equity to FG&E. For instance, the

1 Company requested, and the Department approved an allowed a return on  
2 common equity of 10.58% in the determination of the carrying charge on the  
3 unrecovered balance of generation investment in its transition charge. Further,  
4 the Department found 11% to be the cost of common equity for Fitchburg Gas &  
5 Electric Light Company's gas division in its order in the Company's last gas base  
6 rate case D.T.E. 98-51, Page 127. In addition, the returns are certainly well in  
7 excess of returns on common equity authorized by New England commissions for  
8 other regulated utilities in recent years, as indicated by the following:

<u>COMPANY</u>	<u>DOCKET NUMBER</u>	<u>DATE</u>	<u>ROE</u>
Connecticut Light and Power Co.	DPUC 98-01-02	2/5/1999	10.3%
Bangor Hydro-Electric Co.	PUC 97-596	11/24/1999	11.0%
Narragansett Electric Co., Blackstone Valley Electric Co., Newport Electric Corp.	PUC 2930	3/24/2000	10.5%

19  
20 Q. Is the excess return being earned by FG&E a transient phenomenon?

21 A. Obviously not. The excess returns have existed for the three years shown on  
22 Exhibit DJE-1, Page 1. Based on the net operating income earned by FG&E in  
23 1995 and 1996, there were excess returns of a similar magnitude in those years.  
24 The electric rates being charged by FG&E have produced excess returns over a  
25 number of years. Furthermore, it appears from the Company's current projections  
26 of its financial results that were distributed by the Company at the Department's  
27 public hearing on December 14, 2000 that the excess returns continued into the  
28 year 2000 (see Exhibit DJE-2). Given the experience over these years, the excess  
29 returns being earned by FG&E appear to be permanent and recurring.

30 Q. When was the Company's last base rate increase?

1 A. It is my understanding that the Company's last base rate increase was in 1984. I also  
2 understand that FG&E reduced its base rates in 1993.

3

4 Q. Of what relevance is this in addressing the Company's present excess rate of return?

5 A. If anything, this would be further indication that the excess returns are a permanent  
6 phenomenon. If FG&E earned a return on common equity in the neighborhood of  
7 20% more than fifteen years after its last base rate increase, it clearly has not been  
8 suffering from attrition as the result of increasing costs. The excess returns are stable  
9 and are not eroding over time.

10

11 Q. Would reducing the electric distribution rates being charged by FG&E cure the  
12 excess return problem?

13 A. Yes. Reducing distribution rates would reduce revenue and operating income and  
14 would bring the return on common equity earned by FG&E to a rate more in line with  
15 its actual cost of equity.

16

17 Q. What level of excess revenue is implied by the excess return on equity earned by the  
18 Company?

19 A. Using 1999, which is the latest year for which I have actual data, FG&E earned a  
20 return on common equity of 18.25% from electric operations. If the Company's cost  
21 of common equity is 10.58%, which is the return on common equity used in the  
22 calculation of carrying charges in the Fixed Component of the Transition Charge,  
23 then the excess return on common equity was 7.67% (Exhibit DJE-1, Page 1).

1 Applying this to the common equity supporting electric rate base of \$25,084,000, the  
2 excess earnings were \$1,923,000. To reduce after-tax income by \$1,923,000, pre-tax  
3 revenue must be reduced by \$3,116,000.

4 If revenue is reduced by \$3,116,000, state and federal income taxes will be  
5 reduced by \$1,193,000 ( $\$3,116,000 \times .3829$ ), resulting in a net reduction to income  
6 of \$1,923,000. As I show on Exhibit DJE-1, Page 1, under the column headed "Pro  
7 Forma" a rate reduction of \$3,116,000 will result in a return on common equity of  
8 10.58% and no excess income or excess revenue.

9

10 Q. Would a prospective rate decrease to reduce future annual electric distribution  
11 revenue constitute retroactive ratemaking?

12 A. No. A prospective rate decrease would not entail a refund to customers for excess  
13 earnings in prior years. The purpose of a prospective rate decrease is to bring future  
14 returns to a rate closer to the Company's cost of common equity. This is entirely  
15 appropriate for a company whose rates are intended to be based on the cost of service,  
16 as FG&E's distribution rates still are.

17

18 Q. Would a prospective rate decrease to address an excessive return on common equity  
19 constitute single-issue ratemaking?

20 A. No. Single-issue ratemaking entails an adjustment to rates to address a change to a  
21 single component of revenue or expense in isolation, without reference to the  
22 adequacy of rates absent such a rate adjustment. For example, if a change to a utility  
23 company's depreciation rates increase its depreciation expense by \$1 million, a

1 single-issue rate case would increase its rates to produce \$1 million in additional  
2 revenue, without investigating whether such a rate increase was actually required to  
3 achieve a compensatory rate of return.

4 The calculation of the earned return on common equity takes into account all  
5 relevant revenues and expenses. By definition, a rate change based on the actual  
6 earned rate of return cannot constitute single-issue ratemaking.

7  
8 Q. Please summarize your testimony.

9 A. FG&E electric operations have been producing excess returns for several years.  
10 These excess returns are the result of electric distribution revenues in excess of the  
11 electric distribution cost of service. Based on the results of operations for 1999,  
12 FG&E earned excess distribution revenues of \$3,116,000 in that year.

13  
14 Q. Does this conclude your testimony?

15 A. Yes.

16